Internal Revenue Service

memorandum

CC:TL-N-10480-89
JMPanitch

date: NOV 20 1989

to: District Counsel, Hartford

from: Assistant Chief Counsel (Tax Litigation)

subject: [redacted] Docket No. [redacted]
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This memorandum responds to your third request for our advice in the above-referenced matter. With this latest request, dated September 28, 1989, you have conveyed to us petitioners' undated Supplemental Brief in Support of Taxpayers. You have asked us to focus on the portion of petitioners' brief discussing the "centralization of management" factor of Treas. Reg. § 301.7701-2(a).

ISSUE

Whether [redacted] has "centralization of management" as that term is defined in Treas. Reg. § 301.7701-2(c).

CONCLUSION

Even assuming the truth of petitioners' counsels' factual representations, [redacted] had "centralized management" as that term is defined in Treas. Reg. § 301.7701-2(c).

DISCUSSION

Facts: [1]

In [redacted], certain promoters approached investors with an oil drilling investment program. Brief, p. 2. The promoters had been selling similar investment programs since [redacted] and had

[1] We collected the facts from three sources: 1) [redacted] agreement (the Agreement); 2) Brief in Support of Taxpayers' Position (Brief); and 3) Supplemental Brief in Support of Taxpayers' Position (Supplemental Brief).

successfully organized [redacted] previous programs as trusts. Brief, p. 2. The promoters offered the investors [redacted] units of participation at $[redacted] per unit (total capital = $[redacted]) to [redacted], complete and produce [redacted] oil wells in [redacted]. Brief, p. 2-3. Prior to [redacted], [redacted] investors paid $[redacted] into an escrow account entitled "[redacted], Escrow Account" at the [redacted]. Brief, p. 3.

On [redacted], two unrelated individuals assigned their mineral interests [2] in [redacted] well sites located on Tract [redacted] of [redacted], [redacted], [redacted] to [redacted], doing business as [redacted]. Brief, p. 3. [redacted] was not a participant investor. Brief, p. 3. Also on [redacted], the investors, [redacted] entered into an agreement described immediately below. [3] Agreement, p. 1.

Pursuant to the agreement, the investors conveyed their rights in the mineral interests to the Trustee/Bank. [4] Agreement, p. 1-2; Brief, p. 3. The investors appointed [redacted] as "operator, to act on their behalf in concert with the trustee or any other party, firm, or corporation, to carry out the intent and purpose of [the] agreement." Agreement, p. 3. The investors retained "the right at any time to remove the operator by vote of two-thirds of the beneficial interest and to designate a replacement operator by vote of the majority of the beneficial interests." Agreement, p. 3.

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[2] Unrelated owners of tract [redacted] had leased the mineral interests to the unrelated individuals and had retained a [redacted] royalty interest. Brief, p. 3.

[3] [redacted], as agent for the [redacted] investors, executed a document entitled "[redacted]" (the Agreement), naming the Bank as trustee. Brief, p. 3. The Trustee/Bank also executed the Agreement. Brief, p. 3. In addition, the [redacted] investors executed "schedule A's" attached to the Agreement. Brief, p. 3.

[4] The Agreement initially defines [redacted] as the Grantors. Agreement, p.1. However, the Agreement uses the term "the Grantors" to refer to the investors and the term "the Grantor" to refer to [redacted]. Agreement, p. 1-3. In addition, the agreement defines the trust's beneficiaries as the investors, their heirs, executors, administrators or assigns, as set forth on the schedules attached to the agreement. We will use the term "investors" to refer to the grantor/beneficiary group and "the Operator" to refer to [redacted]

The agreement empowered the Operator "to conduct all drilling and production operations under this trust." [Emphasis added.] Agreement, pp. 3-4. The agreement gave the Operator "all authority to conduct such operations that, within his sole judgment and discretion, [would] develop the leaseholds in the optimum manner." [Emphasis added.] Agreement, p. 4. The agreement required the Operator to "conduct all operations [there]under in diligent, careful, and workmanlike manner in accordance with good oil field practice...." [Emphasis added.] Agreement, p. 4. The agreement authorized the Operator to delegate his duties to others and to "hire and maintain employees, attorneys, engineers, and any other personnel that [he might] deem necessary to fully develop the aforesaid leaseholds, including the right to enter into contracts with said party or parties." [Emphasis added.] Agreement, pp. 4-5. The agreement gave the Operator "the final judgment and decision concerning operations pursuant to th[e] agreement, including, but without limitation, matters relating to explorations, drilling, methods of production, marketing of oil and gas, and abandonment of the wells." [Emphasis added.] Agreement, p. 5.

Contemporaneously with the execution of the Agreement and the assignment of the mineral interests to the Trustee/Bank, the Operator entered into a management agreement with [redacted], of [redacted], to conduct the drilling, equipping and production of the [redacted] wells. The Operator then instructed the Trustee/Bank to pay out $[redacted] to [redacted] for the following turnkey prices:

Sites	$[redacted]
Tank Farm	$[redacted]
Wells ([redacted])	
Tangible Costs	$[redacted]
Intangible Costs	$[redacted]
	$[redacted]

Brief, p. 4.

"It is customary business practice in the drilling and production of oil and gas for the owners of leases to contract with a drilling company to drill the wells, assemble the well head equipment and connect the well to a pipeline and perform all field operations because the owners of mineral leases do not have the required expertise." [Emphasis added.] Supplemental Brief, pp. 11-12. The drilling company's performance is monitored. Supplemental Brief, p. 12. If the drilling company performs poorly, a replacement drilling company is selected. Supplemental Brief, p. 12. [redacted] issued periodic production and status reports to the investors. The reports listed current selling prices and gave general forecasts of future prices. Supplemental Brief, p.

12. Additionally, the reports informed the investors of shutins required by a gas purchaser and gave alternative solutions to minimize shutins. Supplemental Brief, p. 12. Each report informed investors that they could phone [redacted] with any questions they might have. Supplemental Brief, p. 12. [redacted] also sent annual financial statements and tax reporting forms to each investor. Supplemental Brief, p. 12.

The agreement between the Operator and [redacted] concerning the delegation of the Operator's duties under the Agreement was very similar to the "Model Form Operating Agreement" issued by the [redacted]. Supplemental Brief, p. 14. The oil and gas industry uses the Model Form for all types of entities. Supplemental Brief, p. 14. Similar to the Operator under the Agreement, the operator under the Model Form has full control of all operations in the contract area. Supplemental Brief, p. 14.

On at least one occasion, the investors have replaced the trustee of [redacted]. Supplemental Brief, p. 11. It appears that the Operator remained in power for the entire life of the organization. Supplemental Brief, p. 11.

Analysis:

Issue: Whether [redacted] has "centralization of management" as that term is defined in Treas. Reg. § 301.7701-2(c).

As noted above, the agreement gave the Operator the authority necessary to develop the leaseholds in the optimum manner. Agreement, p.4. The Agreement empowered the Operator to exercise this authority in his sole discretion and judgment. Agreement, p. 4. The agreement authorized the Operator to bind the enterprise in contract. Agreement, pp. 4-5. The agreement gave the Operator "the final judgment and decision concerning operations

pursuant to th[e] agreement." Agreement, p. 5. Under Treas. Reg. § 301.7701-2(c), then, it appears beyond doubt that [redacted] had centralized management.[5]

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[5] Treas. Reg. § 301.7701-2(c) provides, in pertinent part:

> (1) An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed....
>
> (3) Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus there is no centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.
>
> (4) There is no centralization of continuing exclusive authority to make management decisions, unless the managers have sole authority to make such decisions. For example, in the case of a corporation or a trust, the concentration of management powers in a board of directors or trustees effectively prevents a stockholder or a trust beneficiary, simply because he is a stockholder or beneficiary, from binding the corporation or trust by his acts. However, because of the mutual agency relationship between members of a general partnership subject to a statute corresponding to the Uniform Partnership Act, such a general partnership cannot achieve effective concentration of management powers and, therefore, centralized management. Usually, the act of any partner within the scope of the partnership business binds all the partners; and even if the partners agree among themselves that the powers of management shall be exclusively in a selected few, this agreement will be ineffective as against an outsider who no notice of it. In addition, limited partnerships subject to a statute

(continued...)

However, petitioners cite Rev. Rul. 88-79, 1988-2 C.B. 361, as support for their assertion that under Treas. Reg. § 301.7701-2(c)(4), [redacted] had no centralized management. In Rev. Rul 88-79, six people formed an organization pursuant to an agreement entitled "Royalty Trust Agreement". The six people formed the organization to buy, hold, and sell oil and gas royalty interests. The agreement referred to the six people as managers.

The managers contributed cash to the organization in exchange for certificates of beneficial interest. In addition, the general public purchased certificates of beneficial interest pursuant to a public offering registered with the Securities and Exchange Commission. The managers owned ten-percent of the shares of beneficial interest while the participants owned the remaining ninety-percent. The certificates of beneficial interest entitled their owners to participate in the organization's profits and losses and to share in the organization's assets upon its liquidation.

The agreement reposed all control and managerial authority in the managers. The agreement designated a commercial bank to serve as trustee. The agreement limited the trustee's responsibility to holding legal title to the trust's assets. The agreement empowered the managers to replace the trustee at any time.

In discussing the "centralization of management" factor, Rev. Rul. 88-79 focuses on the portion of subparagraph (4) of Treas. Reg. § 301.7701-2(c) specific to limited partnerships. The ruling notes that under the agreement, the managers have

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[5](...continued)

> corresponding to the Uniform Limited Partnership Act, generally do not have centralized management, but centralized management ordinarily does exist in such limited partnerships if substantially all the interests in the partnership are owned by the limited partners. Furthermore, if all or a specified group of the limited partners may remove a general partner, all the facts and circumstances must be taken into account in determining whether the partnership possesses centralized management. A substantially restricted right of the limited partners to remove the general partner (e.g., in the event of the general partner's gross negligence, self-dealing, or embezzlement) will not itself cause the partnership to possess centralized management. [Emphasis added.]

continuing exclusive authority to make management decisions. The ruling draws an analogy between the managers and general partners in a limited partnership. Moreover, the ruling draws an analogy between the participants and limited partners. The ruling observes that the participants were not authorized to participate in any management decisions and owned substantially all the interests in the trust. The ruling concludes that the trust had "centralized management" as that term is used in Treas. Reg. § 301.7701-2(c).

Petitioners argue that the analysis of the "centralization of management" factor contained in Rev. Rul. 88-79 applies to [redacted]. Petitioners, however, distinguish the facts of Rev. Rul. 88-79 and conclude that [redacted] lacked centralized management. In reaching this conclusion, petitioners note that the investors could remove the Operator, [redacted], by a two-thirds majority at any time without cause. Petitioners also observe that there was no privity of contract between the investors and [redacted], and, therefore, [redacted]s ouster would result from [redacted]s removal. In petitioners' view, the investors' ability to remove [redacted] and [redacted] by a two-thirds majority without cause negated any initial appearance of "centralized management".

Moreover, taking a cue from Rev. Rul. 88-79, petitioners analogize [redacted] to a limited partnership. Petitioners contend that the investors' right to remove [redacted] and [redacted] was not substantially restricted. Petitioners observe that under Treas. Reg. § 301.7701-2(c)(4), a substantial restriction on limited partners' rights to remove a general partner will not, by itself, compel a finding that the limited partnership possessed centralized management. Petitioners contend that since a substantially restricted right to remove a general partner does not, by itself, compel the conclusion that the limited partnership has "centralized management", an unfettered right of removal by two-thirds majority without cause compels the conclusion that [redacted] lacked "centralized management".

Petitioners' argument certainly sounds persuasive upon first impression. Under closer scrutiny, however, the true nature of the argument emerges: whether inadvertent or not, the argument is nothing more than a headfake. The Department of Treasury first announced its intention to promulgate the portion of Treas. Reg. § 301.7701-2(c)(4) at issue in its Notice of Proposed Rulemaking, 45 Fed. Reg. 70910 (October 27, 1980). In the Notice, the Department of Treasury invited taxpayers to comment on the proposal. In the preamble to T.D. 7889, 1983-1 C.B. 362, the Department of Treasury discussed the sole comment it received regarding the "limited partnership/removal power" issue:

> The only comment received with respect to this issue suggested that the fact that the limited partners had an unrestricted power to remove a general partner indicated the absence, rather than the presence, of centralized management. An unrestricted power to remove a general partner, however, tends to show that the general partner is managing the partnership in a representative capacity rather than on the partner's own behalf. The power, therefore, is an indication that the partnership possesses centralized management. See Glensder Textile v. Commissioner, 46 B.T.A. 176 (1942). Accordingly, the final regulations adopt this provision of the proposed regulations without change.

Id., at 363.

Glensder Textile involved the classification of a limited partnership organized under New York law. The Board of Tax Appeals found that the limited partnership therein lacked "centralized management" in the corporate sense, because the general partners were following their own interests in managing the limited partnership, rather than managing in a representative capacity. Significant to the Court's determination was the fact that "the limited partners here [were not] able to remove the general partners and control them as agents, as stockholders may control directors." Id., at p. 185. Also see Zuckman v. United States, 524 F.2d 729, 737-38 (Ct.Cl. 1975); Larson v. Commissioner, 66 T.C. 159, 176-78 (1976). Accordingly, under the rationale of T.D. 7889 and Glensder Textile, any analogy drawn between [redacted] and limited partnerships favors the Commissioner; the investors' power to remove the Operator by a [redacted] majority without cause supports the conclusion that the trust had "centralized management". The fact that the Operator had no proprietary interest in the trust also supports this conclusion.

There is no contrary authority on this issue. Moreover, to decide this issue in favor of petitioners, the Court would have to invalidate a portion of the regulation which incorporates the Court's own rationale. Accordingly, we perceive no significant hazards in litigating this issue.

CONCLUSION

Pursuant to T.D. 7889 and Glensder Textile, [redacted] had "centralized management" as that term is used in Treas. Reg. 301.7701-2(c)(4). Assuming the truth of the facts as petitioners have relayed them to us, we are aware of no significant litigating hazards on this issue.

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